

To Microsoft Tax Department

Date February 24, 2007

From Brian Burt

cc

Microsoft PR – Explanation of Model Components

This memo is intended to explain the Source P&L for the Microsoft Puerto Rico Cost Sharing engagement (located on the ‘P&L’ tab in a file titled “20050926_MSFT_PL.xls”). Specifically, our intent is to clarify the various sources of information in the model and discuss the computations that were made using that data. We will begin the memo by describing the data sources used in the buy-in calculation. Next, we will present a summary of the financial/economic computations that were performed, including a description of the assumptions that were used in the model. By the conclusion of the memo, we hope to have created a comprehensive audit trail for the Microsoft Puerto Rico cost sharing P&L.

I. Discussion of Source Information

Our discussion of source information will be limited strictly to historical financial data, as all forecasted figures are calculated based upon assumptions, which are discussed in Section II of this memo. Furthermore, our discussion of source information will be organized according to the line items on the P&L, starting with sales and working through the expense lines:

Total Sales

KPMG obtained historical sales figures for the years 1995-2000 from a Factset CD ROM. The data on this disk came from a worksheet titled ‘Historical P&L’, which was current as of April 19, 2005.

Historical sales figures for the years 2001-2004 came from a file titled “Copy of MS PR PL FY01-FY04 KPMG v5.xls”. Specifically, the data came from cells D58, E58, F58, and G58 for the years 2001-2004, respectively, in a tab titled ‘Americas Sales by Biz Summ’. This information was provided to KPMG by Microsoft.

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Sales information for the year 2005 came from a file titled “FY05 for KPMG R&D and S&M update 9-28-05.xls”. Specifically, the data came from cell H33 in a tab titled ‘05 Amer Ratios’. This information was provided to KPMG by Microsoft.

Cost of Goods Sold (COGS)

KPMG obtained historical COGS figures for the years 1995-2000 from a Factset CD ROM. The data on this disk came from a worksheet titled “Historical P&L”, which was current as of April 19, 2005.

Historical COGS information for the year 2001 came from a file titled “Copy of MS PR PL FY01-FY04 KPMG v5.xls”. Specifically, the 2001 COGS number was derived by taking a sum of the data in cells E33 and F33 in a tab titled ‘WW with COGS & Roy’. This information was provided to KPMG by Microsoft.

Historical COGS information for the year 2002 came from a file titled “Copy of MS PR PL FY01-FY04 KPMG v5.xls”. Specifically, the 2002 COGS number was derived by taking a sum of the data in cells H33 and I33 in a tab titled ‘WW with COGS & Roy’. This information was provided to KPMG by Microsoft.

Historical COGS information for the year 2003 came from a file titled “Copy of MS PR PL FY01-FY04 KPMG v5.xls”. Specifically, the 2003 COGS number was derived by taking a sum of the data in cells K33 and L33 in a tab titled ‘WW with COGS & Roy’. This information was provided to KPMG by Microsoft.

Historical COGS information for the year 2004 came from a file titled “Copy of MS PR PL FY01-FY04 KPMG v5.xls”. Specifically, the 2004 COGS number was derived by taking a sum of the data in cells N33 and O33 in a tab titled ‘WW with COGS & Roy’. This information was provided to KPMG by Microsoft.

COGS information for the year 2005 came from a file titled “MS Sales COGS update FY01-FY05 (flat file) (3).xls”. Specifically, the data came from cell D41 in a tab titled ‘FY05 PR COGS’. This information was provided to KPMG by Microsoft.

General and Operating Expenses

KPMG obtained historical General and Operating Expense information for the year 2001 came from a file titled “FY01 – Americas R&D and S&M KPMG.xls”. Specifically, the data came from cell E50 in a tab titled ‘FY01 Americas G&A’. This information was provided to KPMG by Microsoft.

General and Operating Expense information for the year 2002 came from a file titled “FY02-Americas R&D and S&M.xls”. Specifically, the data came from cell C36 in a tab titled ‘FY02 G&A’. This information was provided to KPMG by Microsoft.

General and Operating Expense information for the year 2003 came from a file titled “FY03-Americas R&D and S&M--final.xls”. Specifically, the data came from cell C35 in a tab titled ‘FY03 Americas G&A’. This information was provided to KPMG by Microsoft.

General and Operating Expense information for the year 2004 came from a file titled “FY04-Americas R&D and S&M.xls”. Specifically, the data came from cell D693 in a tab titled ‘FY04 Americas G&A’. This information was provided to KPMG by Microsoft.

General and Operating Expense information for the year 2005 came from a file titled “FY05 for KPMG non-IDC SM (flat file) 9-30-05 (4) (2).xls”. Specifically, the data came from cell D11 in a tab titled ‘05 AMER G&A Totals’. This information was provided to KPMG by Microsoft.

Routine Sales and Marketing Expenses

KPMG obtained historical Routine Sales and Marketing Expense information for the year 2001 from a file titled “FY01 – Americas R&D and S&M KPMG.xls”. Specifically, the data came from cell E50 in a tab titled ‘FY01 Americas S&M’. This information was provided to KPMG by Microsoft.

Routine Sales and Marketing Expense information for the year 2002 came from a file titled “FY02 – Americas R&D and S&M KPMG.xls”. Specifically, the data came from cell E37 in a tab titled ‘FY02 Americas S&M’. This information was provided to KPMG by Microsoft.

Routine Sales and Marketing Expense information for the year 2003 was calculated with information from two different files. Specifically, we subtracted the value in cell L26 of tab ‘P&L’ (file name “Copy of MS PR PL FY01-FY04 KPMG v5.xls”) from the value in cell E53 of tab ‘FY03 Americas S&M’ (file name “FY03-Americas R&D and S&M KPMG.xls”). The information in cell E53 was provided to KPMG by Microsoft, and the origin of the information in cell L26 is discussed in the Marketing IDC section below.

Routine Sales and Marketing Expense information for the year 2004 was also calculated with information from two different files. Specifically, we subtracted the value in cell M26 of tab ‘P&L’ (file name “Copy of MS PR PL FY01-FY04 KPMG v5.xls”) from the value in cell E48 of tab ‘FY04 Americas S&M’ (file name “FY04-Americas R&D and S&M KPMG.xls”). The information in cell E48 was provided to KPMG by Microsoft, and the origin of the information in cell M26 is discussed in the Marketing IDC section below.

Routine Sales and Marketing Expense information for the year 2005 came from a file titled “FY05 for KPMG non-IDC SM (flat file) 9-30-05 (4) (2).xls”. Specifically, the data came from cell C56 in a tab titled ‘05 Amer non-IDC S&M’. This information was provided to KPMG by Microsoft.

R&D IDC

KPMG obtained historical R&D intangible development costs (“IDC”) information for the years 1995 and 1996 from a Factset CD ROM. The data on this disk came from a worksheet titled ‘Historical P&L’, which was current as of April 19, 2005. We multiplied the Factset numbers by the *Assumed Americas share of WW revenue and costs* (located in cell C13 of a tab titled ‘P&L Assumptions’ in a file titled “Copy of MS PR PL FY01-FY04 KPMG v5.xls”) to arrive at the final R&D IDC figures.

R&D IDC information for the year 1997 came from a file titled “FY97 data.xls”. Specifically, the data came from cell C41 in a tab titled ‘Tie out to SEC’. This information was provided to KPMG by Microsoft.

R&D IDC information for the year 1998 came from a file titled “FY98 data.xls”. Specifically, the data came from cell D46 in a tab titled ‘SEC Tie Out’. This information was provided to KPMG by Microsoft.

R&D IDC information for the year 1999 came from a file titled “FY99 Data.xls”. Specifically, the data came from cell D46 in a tab titled ‘Tie Out and R&D’. This information was provided to KPMG by Microsoft.

R&D IDC information for the year 2000 came from a file titled “FY00 Data set.xls”. Specifically, the data came from cell D33 in a tab titled ‘SEC Tie Out’. This information was provided to KPMG by Microsoft.

R&D IDC information for the year 2001 came from a file titled “FY01-Americas R&D and S&M--Final.xls”. Specifically, the data came from cell C42 in a tab titled ‘FY01 Americas R&D’. This information was provided to KPMG by Microsoft.

R&D IDC information for the year 2002 came from a file titled “FY02-Americas R&D and S&M.xls”. Specifically, the data came from cell C30 in a tab titled ‘FY02 R&D’. This information was provided to KPMG by Microsoft.

R&D IDC information for the year 2003 came from a file titled “FY03-Americas R&D and S&M--final.xls”. Specifically, the data came from cell C42 in a tab titled ‘FY03 Americas R&D’. This information was provided to KPMG by Microsoft.

R&D IDC information for the year 2004 came from a file titled “FY04-Americas R&D and S&M.xls”. Specifically, the data came from cell C36 in a tab titled ‘FY04 Americas R&D’. This information was provided to KPMG by Microsoft.

R&D IDC information for the year 2005 came from a file titled “FY05 for KPMG R&D and S&M update 9-28-05.xls”. Specifically, the data came from cell C42 in a tab titled ‘05 Amer R&D’. This information was provided to KPMG by Microsoft.

Marketing IDC

KPMG calculated Marketing IDC figures for the years 2001-2004 based upon a ratio of 2005 Marketing IDC to Sales (the derivation of 2005 Marketing IDC is discussed in the paragraph below). In the absence of historical Marketing IDC data in the years 2001-2004, KPMG felt that the 2005 ratio of 6.16 percent was a reasonable basis for estimating Marketing IDC.

Marketing IDC information for the year 2005 came from a file titled “FY05 for KPMG R&D and S&M update 9-28-05.xls”. Specifically, the data came from cell H33 in a tab titled ‘05 Amer S&M 1010’. This information was provided to KPMG by Microsoft.

II. Assumptions and Calculations

After gathering historical P&L figures from the various sources described above, we created forecasted P&L figures based upon the source data and several assumptions. These assumptions, as well as the forecasting calculations, are discussed below.

Total Sales

KPMG determined sales figures for the years 2006-2008 based upon forecasted revenue numbers from Microsoft. This data came from a tab titled “Region” in the “20050926_MSFT_PL.xls” file. More precisely, the total sales number for each year was determined by taking a sum of the forecasted sales information from the product lines Client, S&T, IW, and MBS (cells O7, P7, Q7, and R7 for 2006, for example). After determining the total sales amount that was forecasted for each year, KPMG took that value and multiplied it by the *Assumed 2005 Americas share of WW revenue and costs*. While this percentage can be traced back to cell C13 in the ‘P&L Assumptions’ tab of the “20050926_MSFT_PL.xls” file, the figure was originally provided to KPMG by Microsoft. It should be noted that this percentage is different than the *Assumed Americas share of WW revenue and costs* that was discussed in the R&D IDC section above, as it is specific to 2005.

Forecasted sales figures for each of the years 2009-2022 were calculated by multiplying the preceding year's sales amount by an assumed Compounded Annual Growth Rate ("CAGR") of 5.31%. This CAGR can be traced back to cell C18 in the 'P&L Assumptions' tab of the "20050926_MSFT_PL.xls" file. KPMG employed sales data from 2001 to 2008 in calculating the CAGR, and it also benchmarked the resulting percent against independent analyst reports to verify accuracy and reasonableness.

Cost of Goods Sold (COGS)

KPMG relied entirely on historical COGS information in calculating forecasted COGS figures for the years 2006-2022. Specifically, we calculated COGS in each year by taking a ratio of 2005 COGS to Sales (with the sources of such information described above) and multiplying the resulting fraction by the forecasted sales figure in that year.

General and Operating Expenses

KPMG performed several calculations to back-into the forecasted General and Operating Expenses for the years 2006-2022. First, KPMG calculated forecasted operating profit ("OP") for each of the years 2006-2022. This was done by taking a ratio of 2005 OP to Sales and multiplying that percentage by forecasted sales in each year (this ratio can be traced back to cell C26 in the 'P&L Assumptions' tab of the "20050926_MSFT_PL.xls" file). Through discussion with Microsoft, KPMG determined that the 2005 ratio of OP to Sales was a sensible proxy for estimating forecasted OP.

After calculating forecasted OP figures, we next determined forecasted Total Operating Expenses. This was done by subtracting forecasted OP from forecasted Gross Profit ("GP") in each year (GP was determined by subtracting forecasted COGS from forecasted Sales). Once we determined forecasted Total Operating Expenses, we then calculated a ratio of 2005 General and Operating Expenses to Total Operating Expenses. This percentage can be traced back to cell C9 in the 'P&L Assumptions' tab of the "20050926_MSFT_PL.xls" file. By applying the 2005 ratio to forecasted Total Operating Expenses in each year, we were able to calculate a reasonable projection of General and Operating Expenses over the forecast period of 2006-2022.

Routine Sales and Marketing Expenses

KPMG's determination of forecasted Routine Sales and Marketing Expenses is nearly identical to the methodology followed for the calculation of forecasted General and Operating Expenses described above. The only material difference is that, in the calculation of Routine Sales and Marketing Expense, we multiplied forecasted Total Operating Expenses in each year by a ratio of 2005 Sales and Marketing Expense to Sales. This ratio is calculated in cell C10 in the 'P&L Assumptions' tab of the "20050926_MSFT_PL.xls" file.

R&D IDC

KPMG calculated projected R&D IDC figures for the years 2006-2022 by multiplying forecasted sales in each year by a ratio of 2005 R&D IDC to Sales. This ratio is calculated in cell C24 in the ‘P&L Assumptions’ tab of the “20050926_MSFT_PL.xls” file. Based upon collaborative discussions with Microsoft, KPMG assumed that the ratio of 2005 R&D IDC to Sales was a reasonable basis for forecasting R&D IDC.

Marketing IDC

KPMG calculated projected Marketing IDC in the same fashion that it calculated projected R&D IDC. Specifically, KPMG calculated projected Marketing IDC figures for the years 2006-2022 by multiplying forecasted sales in each year by a ratio of 2005 Marketing IDC to Sales. This ratio is calculated in cell C25 in the ‘P&L Assumptions’ tab of the “20050926_MSFT_PL.xls” file. Based upon collaborative discussions with Microsoft, KPMG assumed that the ratio of 2005 Marketing IDC to Sales was a reasonable basis for forecasting Marketing IDC.

This memo has two key components: 1) a description of the source information that represents the historical financials of the Microsoft PR Source P&L, and 2) a description of the assumptions and calculations that were used by KPMG to determine the forecasted financials of the Source P&L. When combined, these two components provide a complete audit trail for the Source P&L, which is contained in Appendix A.

If you have questions about any of the information presented in this memo, please do not hesitate to contact me at (213) 593-6790 or Anne Welsh at (206) 913-4132.

Very truly yours,

Brian T. Burt

Enclosure

cc: Anne Welsh, KPMG Seattle

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**Appendix A: Microsoft PR Source P&L
Historical Financials**

Revised Forecast as of 9/26/05		discussion purposes only. This model is not intended or developed										
		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Fiscal Year Ending Period		1	2	3	4	5						
Total Sales	1,459,720,900	2,130,464,700	2,790,850,600	3,558,718,800	4,851,837,900	5,640,289,200	7,413,169,345	8,833,338,071	8,752,426,788	8,953,781,601	9,630,235,129	
Total COGS	159,705,000	202,702,500	179,852,400	164,373,300	572,726,700	573,463,800	131,003,442	86,639,716	72,957,078	72,615,012	125,502,214	
Gross Profit	1,299,015,900	1,927,762,200	2,610,808,200	3,384,345,500	4,279,111,200	5,066,825,400	7,282,165,903	8,752,698,355	8,679,472,710	8,881,166,588	9,504,732,914	
General and Operating Expenses							246,888,135	463,746,721	519,837,424	1,228,741,242	1,739,573,846	
Routine Sales and Marketing Expenses							864,524,082	757,804,742	757,255,710	756,780,972	969,174,085	
Total Operating Expenses							1,111,413,217	1,221,551,463	1,277,093,134	1,985,522,215	2,708,747,931	
Operating Profit							6,170,752,686	7,531,146,892	7,402,379,576	6,895,644,374	6,795,984,984	
R&D IDC	211,302,000	351,842,400	723,324,200	878,818,178	935,594,734	1,059,419,430	1,204,282,199	1,240,735,588	1,191,509,942	1,116,845,943	1,147,095,474	
Marketing IDC							456,309,575	543,726,516	538,746,294	551,140,286	592,778,647	
Gross Margin%	69.05%	90.49%	93.56%	95.38%	98.20%	99.83%	98.23%	99.09%	99.17%	99.19%	98.70%	
Operating Margin%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	83.24%	85.28%	84.58%	77.01%	70.57%	

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Appendix A: Microsoft PR Source P&L Forecasted Financials

Revised Forecast as of 9/26/05		demonstration purposes only. This model is not intended or developed																		
		Microsoft Puerto Rico Retail Cost Sharing Source P&L																		
Fiscal Year Ending Period	Forecast Begins	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022		
		6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22		
Total Sales	10,015,696,000	10,600,103,076	11,212,646,103	11,807,882,031	12,434,671,277	13,094,754,102	13,789,876,803	14,521,899,438	15,292,786,807	16,104,582,687	16,559,480,259	17,859,758,417	18,807,825,889	19,806,222,683	20,857,617,379	21,964,234,373	23,130,806,409			
Total COGS	130,525,450	138,141,633	146,124,396	153,881,272	162,049,915	170,852,162	179,711,092	189,297,092	209,676,590	221,017,692	233,750,208	245,105,534	258,116,730	271,818,614	286,247,850	301,443,247				
Gross Profit	9,885,160,550	10,461,961,443	11,066,524,707	11,653,960,759	12,272,821,362	12,924,101,920	13,610,165,710	14,332,648,552	15,093,463,715	15,994,707,096	16,738,462,658	17,627,008,209	18,562,721,355	19,548,105,953	20,585,799,765	21,678,576,523	22,829,363,261			
General and Operating Expenses	1,809,290,417	1,914,767,897	2,025,416,876	2,132,933,173	2,248,167,923	2,365,393,163	2,486,957,770	2,623,187,920	2,762,437,363	2,909,878,772	3,063,504,481	3,225,127,734	3,397,303,690	3,577,730,608	3,767,651,069	3,967,653,292	4,178,272,423			
Routine Sales and Marketing Expenses	1,007,965,749	1,086,789,302	1,128,428,127	1,188,337,667	1,251,108,216	1,317,832,677	1,387,734,903	1,461,464,080	1,539,845,163	1,623,745,533	1,706,779,600	1,787,322,389	1,869,734,742	1,953,271,970	2,049,082,537	2,110,516,779	2,327,365,364			
Total Operating Expenses	2,217,165,765	2,981,547,095	3,153,842,064	3,321,260,739	3,497,565,741	3,683,231,720	3,878,752,674	4,084,652,610	4,361,482,551	4,529,822,705	4,770,284,091	5,023,510,123	5,280,179,431	5,571,002,576	5,866,734,006	6,178,164,061	6,506,126,087			
Operating Profit	7,667,994,784	7,488,413,548	7,912,882,703	8,332,720,019	8,775,054,622	9,240,879,140	9,731,413,037	10,247,995,942	10,792,001,164	11,364,884,292	11,958,179,597	12,603,498,086	13,272,542,924	13,977,103,377	14,719,064,759	15,500,412,463	16,323,237,274			
R&D IDC	1,193,008,056	1,262,620,286	1,335,685,074	1,408,461,245	1,481,142,276	1,569,768,080	1,642,563,580	1,729,760,897	1,821,683,722	1,918,280,790	2,020,110,921	2,127,346,609	2,240,274,802	2,369,976,682	2,484,439,471	2,616,317,285	2,755,202,026			
Marketing IDC	616,504,656	652,477,313	690,182,418	726,820,102	765,402,665	806,033,343	848,821,865	883,879,722	941,330,466	991,300,129	1,043,922,364	1,099,338,000	1,157,695,324	1,219,50,491	1,283,887,948	1,362,020,870	1,423,781,825			
Gross Margin%	98.70%	98.70%	98.70%	98.70%	98.70%	98.70%	98.70%	98.70%	98.70%	98.70%	98.70%	98.70%	98.70%	98.70%	98.70%	98.70%	98.70%			
Operating Margin%	70.57%	70.57%	70.57%	70.57%	70.57%	70.57%	70.57%	70.57%	70.57%	70.57%	70.57%	70.57%	70.57%	70.57%	70.57%	70.57%	70.57%			